

## Message Text

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ACTION EUR-12

INFO OCT-01 IO-13 ISO-00 CIAE-00 DODE-00 NSAE-00  
NSCE-00 SSO-00 ICAE-00 INRE-00 SP-02 AID-05 EB-08  
TRSE-00 SS-15 STR-07 OMB-01 CEA-01 COME-00 FRB-03  
INR-10 XMB-02 OPIC-03 LAB-04 SIL-01 L-03 H-01  
PA-01 MMO-01 CTME-00 /094 W  
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O 111646Z MAY 78  
FM AMEMBASSY MADRID  
TO SECSTATE WASHDC IMMEDIATE 4561  
INFO AMEMBASSY BONN  
AMEMBASSY BRUSSELS  
AMEMBASSY COPENHAGEN  
AMEMBASSY DUBLIN  
USMISSION GENEVA  
AMEMBASSY LISBON  
AMEMBASSY LONDON  
AMEMBASSY LUXEMBOURG  
AMEMBASSY PARIS  
AMEMBASSY ROME  
AMEMBASSY THE HAGUE

C O N F I D E N T I A L SECTION 01 OF 03 MADRID 05205

BRUSSELS ALSO FOR USEEC

PARIS ALSO FOR USOECD

E.O. 11652:GDS  
TAGS: PINT, ECON, EFIN, SP  
SUBJ: THE SPANISH ECONOMY: ABOUT HALFWAY THERE

REF: MADRID 4508, JUNE 1977; MADRID 4669 (NOTAL);  
MADRID 4806 (NOTAL)

1. SUMMARY: AFTER SOME NINE MONTHS OF EFFORT THE SPANISH  
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AUSTERITY PROGRAM IS PAYING OFF. IMPORTANT PROGRESS HAS  
BEEN MADE IN REDUCING RUNAWAY INFLATION. THE CURRENT  
ACCOUNT DEFICIT HAS BEEN REDUCED TO MANAGEABLE PROPORTIONS.  
A CONSIDERABLE AMOUNT OF KEY STRUCTURAL REFORM MEASURES  
HAVE BEEN DRAWN UP, AND IN MANY CASES PUT INTO EFFECT.  
THE COST HAS BEEN HIGH THOUGH, AS CONTINUED RECESSION HAS  
MEANT INCREASED UNEMPLOYMENT, MINIMAL GROWTH, LOW BUSINESS

PROFITS AND A DECLINE IN NET CAPITAL FORMATION. SPAIN  
FACES AT LEAST ANOTHER YEAR OR TWO OF HARD TIMES; AND THE  
JURY IS STILL OUT ON WHEN, AND IF, INVESTOR CONFIDENCE  
IN THE POLITICAL AND ECONOMIC FUTURE OF THE COUNTRY WILL  
BE RESTORED. IF THE GOVERNMENT IS ABLE TO STICK TO ITS  
AGREED UPON ECONOMIC AND SOCIAL POLICIES, AND, IMPORTANT-  
LY, THE POLITICAL EVOLUTION CONTINUES SMOOTHLY, MID-TO-  
LATE 1979 SHOULD SEE AT LEAST THE BEGINNINGS OF A RE-  
SUMPTION OF GROWTH. IF THE STRUCTURAL REFORMS HAVE TAKEN  
HOLD, THAT GROWTH SHOULD BE ON A SOUNDER, MORE MARKET-  
ORIENTED, AND THUS MORE SUSTAINABLE, BASIS. END SUMMARY.

2. BACKGROUND: ECONOMIC GROWTH IN THE LATER FRANCO YEARS  
WAS RAPID (7 PERCENT PER YEAR, 1970-75), BUT BADLY SKEWED.  
HIGH PROTECTIVE BARRIERS, FAVORITISM IN THE ALLOCATION  
OF CREDIT AND MINIMAL TAXATION ARTIFICIALLY CHANELLED  
RESOURCES, BOTH DOMESTIC AND FOREIGN, INTO INDUSTRIES  
THAT IN MANY CASES WERE INEFFICIENT AND UNCOMPETITIVE  
ON THEIR OWN. STRICT LABOR DISCIPLINE WAS ENFORCED,  
IN RETURN FOR STEADY INCREASES IN REAL WAGES AND JOB  
SECURITY LAWS MAKING IT ALMOST IMPOSSIBLE TO FIRE EXCESS  
WORKERS IN TIMES OF SLOWDOWN. WHILE ENERGY WAS CHEAP,  
AND THE ECONOMIES OF SPAIN'S MAJOR TRADING PARTNERS WERE  
FLOURISHING, SPAIN HAD A CONSTANTLY INCREASING MARKET  
FOR ITS EXPORTS, STEADY GROWTH OF TOURISM, AND JOBS FOR  
ITS UNEMPLOYED WORKERS TO EMIGRATE TO. BUT THE OIL CRISIS  
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OF 1973-74 AND SUBSEQUENT RECESSION IN THE WESTERN WORLD  
PUT A HALT TO ALL THAT. OVER THE NEXT THREE YEARS, GROWTH  
DECLINED DRASTICALLY, DEMAND FLATTENED OUT, UNEMPLOYMENT  
WENT UP, NET INVESTMENT DECREASED, THE CURRENT ACCOUNT  
MOVED INTO LARGE SCALE DEFICITS AND INFLATION ACCELERATED.  
FRANCO'S DEATH IN LATE 1975 LED THE GOVERNMENT TO CON-  
CENTRATE ALL ITS ENERGIES ON THE POLITICAL TRANSITION.  
THE ECONOMY WAS LARGELY LEFT TO DRIFT THROUGHOUT 1976  
AND EARLY 1977, THUS EXACERBATING THE ECONOMIC CRISIS.  
NATIONAL ELECTIONS WERE FINALLY HELD IN JUNE 1977 AND A  
GOOD START MADE ON ASSURING THE TRANSITION TO A FUNCTION-  
ING, REASONABLY STABLE POLITICAL SYSTEM. THE GOVERNMENT  
THEN TURNED ITS ATTENTION TO THE ECONOMY.

3. STABILIZATION AND ECONOMIC REFORM PROGRAM.  
THE MOST IMMEDIATE PROBLEMS IN MID-1977 WERE AN INFLATION  
RATE THAT WAS APPROACHING 30 PERCENT AND A CURRENT ACCOUNT  
DEFICIT THAT WAS HEADED FOR \$4 BILLION OR MORE. TO COM-  
POUND THE PROBLEM, THE PESETA WAS OVERVALUED, THUS  
SUBSIDIZING IMPORTS AND DRIVING UP THE PRICE OF EXPORTS.  
FOREIGN EXCHANGE RESERVES WERE BEING RUN DOWN AND EXTERNAL  
DEBT PILED UP IN A FUTILE EFFORT TO DEFEND THE PESETA.

MASSIVE AMOUNTS OF SPECULATIVE CAPITAL WERE FLEEING THE COUNTRY IN ANTICIPATION OF DEVALUATION.

- THE GOVERNMENT'S RESPONSE WAS ALONG TWO MAIN LINES: A SERIES OF IMMEDIATE STABILIZATION MEASURES; COUPLED WITH VERY AMBITIOUS PLANS FOR MAJOR STRUCTURAL REFORM OF THE ECONOMY TO RESTORE MARKET DISCIPLINE IN THE ALLOCATION OF CREDIT AND RESOURCES AND PROVIDE GREATER SOCIAL EQUITY.

- THE PESETA WAS DEVALUED BY 20 PERCENT IN JULY AND A "MANAGED FLOAT" INSTITUTED. AFTER SOME DELAY, BUT WITH HIGHLY PROFESSIONAL PREPARATION, AND THE SIGNED AGREEMENT OF ALL POLITICAL PARTIES, INCLUDING LABOR GROUPS AND THE COMMUNISTS, A SERIES OF PROGRAMS KNOWN AS THE MONCLOA

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O 111646Z MAY 78  
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C O N F I D E N T I A L SECTION 02 OF 03 MADRID 05205

BRUSSELS ALSO FOR USEEC PARIS ALSO FOR USOECD

PACTS WERE PUT INTO EFFECT IN OCTOBER 1977. IT WAS A TOUGH, THOROUGH-GOING, BUT CAREFULLY BALANCED PROGRAM THAT CALLED FOR ALL PARTIES - LABOR, BUSINESS, BANKS AND THE GOVERNMENT - TO SUFFER MORE OR LESS EQUALLY IN THE ATTEMPT TO CUT DOWN INFLATION, REDRESS THE CURRENT ACCOUNT DEFICIT AND ABOVE ALL MOVE THE ECONOMY TO A MORE FLEXIBLE, EQUITABLE AND EFFICIENT FOOTING.

- MONETARY POLICY WAS TO BE THE MAIN MACROECONOMIC TOOL. GUIDELINES CALLED FOR THE INCREASE IN MONEY SUPPLY (M3)  
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TO BE SCALED DOWN FROM 21 PERCENT FOR FIRST HALF 1977 TO 17 PERCENT IN THE SECOND HALF; AND THE SAME FOR 1978. THIS TARGET IS BEING MET. IN FACT THE ACTUAL GROWTH IN THE MONETARY AGGREGATES HAS BEEN EVEN LESS THAN PLANNED (16.1 PERCENT MOVING AVERAGE GROWTH IN DECEMBER-JANUARY-FEBRUARY). BUT THE INITIAL, AND QUITE SEVERE TIGHTENING OF THE SCREWS IN MID-TO-LATE 1977 DROVE SHORT TERM RATES TO HISTORIC HIGHS (OVER 20 PERCENT) AND HELPED TO PUT SOME BANKS AND MANY BUSINESSES IN TROUBLE. MONEY IS MORE READILY AVAILABLE NOW, AND FAIRLY CHEAPLY, BUT THIS IS IN CONSIDERABLE PART BECAUSE THERE ARE FEW TAKERS AND DEMAND CONTINUES TO BE VERY FLAT.

- THE SECOND PART OF THE PLAN CALLED FOR CURBS ON WAGE COSTS. RAPID AND CONTINUING ACCELERATION IN LABOR COSTS HAD BECOME AN IMPORTANT CAUSE OF INFLATION. THE MONCLOA PACTS CALLED FOR LIMITING TOTAL WAGE INCREASES TO 22 PERCENT IN 1978. REAL WAGE INCREASES WERE TO BE CONCENTRATED IN THE LOWER RANGE OF SALARIES. THESE TARGETS ARE ALSO BEING MET, EVEN IN THE MIDST OF A LONG SERIES OF LABOR "PLANT COMMITTEE" ELECTIONS, (THE FIRST FREE TRADE UNION ELECTIONS IN OVER 40 YEARS); AND A TROUBLESOME STRING OF STRIKES AND WORK STOPPAGES IN KEY SECTORS.

- THE PLAN'S INFLATION TARGETS ARE 17 PERCENT IN 1978 AND 10 PERCENT IN 1979. INFLATION WAS ABOUT 14-16 PERCENT ON AN ANNUAL BASIS IN THE FIRST QUARTER OF 1978, A HEALTHY IMPROVEMENT FROM THE 30 PERCENT RATE OF MID-1977.

- FISCAL POLICY IN 1978 IS DESIGNED TO BE NEAR NEUTRAL IN TERMS OF EFFECT ON DEMAND BY HOLDING BACK ON GOVERNMENT SPENDING. IN FACT INCREASED REVENUES FROM NEWLY COLLECTED TAXES, ADDED TO TRADITIONALLY SLOW SPENDING OF BUDGETED MONIES, HAS RESULTED IN SURPLUSES SO FAR

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THIS YEAR, WHICH HAVE EXERTED A STRONGER THAN ANTICIPATED FISCAL DRAG ON THE ECONOMY.

- SELECTIVE EXPENDITURES ARE ALSO CALLED FOR TO ASSIST SPECIFIC SECTORS AND REGIONS WHERE UNEMPLOYMENT IS SERIOUS.

4. STRUCTURAL REFORMS. WHILE THE AUSTERITY PROGRAM HOLDS DOWN DOMESTIC DEMAND SO THAT INFLATION CAN BE REDUCED AND THE CURRENT ACCOUNT DEFICIT IMPROVED, BASIC STRUCTURAL REFORMS ARE BEING DESIGNED AND IMPLEMENTED.

- THREE MAJOR TAX REFORM PACKAGES HAVE BEEN SUBMITTED TO THE CORTES AND MANY OF THE NEW MEASURES ARE ALREADY IN EFFECT. EQUITY AND EFFICIENCY ARE THE OBJECTIVES. THE OLD TAX SYSTEM, INCLUDING SOCIAL SECURITY, IS HEAVILY REGRESSIVE. CHEATING BY THE WEALTHY WAS NOTORIOUS. BOTH DIRECT AND INDIRECT TAXES ARE TO BE REFORMED. IF APPROVED AS DRAFTED, THERE WILL BE A SINGLE, PROGRESSIVE TAX ON THE INCOME OF INDIVIDUALS, A TAX ON CAPITAL AND A TAX ON INHERITED WEALTH. IT WILL TAKE SEVERAL YEARS UNTIL SPANIARDS GET ACCUSTOMED TO PAYING THEIR FAIR SHARE OF TAXES, AND UNCERTAINTY OVER EXACTLY HOW MUCH THE BILL WILL BE, AND WHETHER PRIOR VIOLATORS WILL BE PROSECUTED, HAS CONTRIBUTED SIGNIFICANTLY TO BUSINESSMEN'S UNWILLINGNESS TO MAKE NEW COMMITMENTS. NEVERTHELESS, REFORM OF THE FISCAL SYSTEM IS A PREREQUISITE FOR HOLDING LABOR AND SOCIALIST SUPPORT FOR THE AUSTERITY PROGRAM. AND A MORE PROGRESSIVE, EQUITABLE SYSTEM WILL, OVER TIME, GIVE THE GOVERNMENT SUFFICIENT REVENUE TO PLAY A MORE ACTIVE ROLE IN THE HERETOFOR SADLY NEGLECTED SOCIAL WELFARE FIELD.

- THE MONEY MARKET AND CREDIT SYSTEMS ARE BEING REFORMED TO IMPROVE THE ALLOCATION OF RESOURCES TO THE MOST EFFICIENT USERS. A SECONDARY MARKET IS BEING DEVELOPED TO INCREASE THE EFFICIENCY OF MONETARY POLICY AS WELL AS MOBILIZE FUNDS FOR INVESTMENT. THIS LAST IS A SLOW PRO-  
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C O N F I D E N T I A L SECTION 03 OF 03 MADRID 05205

BRUSSELS ALSO FOR USEEC PARIS ALSO FOR USOECD

CESS THAT IS DEPENDENT ON TIGHTER CONTROL OF INFLATION  
TO MAKE MARKET INSTRUMENTS LIKE MORTGAGES AND BONDS  
ATTRACTIVE INVESTMENTS. A FULLY FUNCTIONING MONEY MARKET  
IS THUS SEVERAL YEARS AWAY.

- AS SPAIN MOVES TO JOIN THE EEC OVER THE NEXT THREE TO  
FIVE YEARS, LARGE PARTS OF THE PROTECTIVE BARRIERS THAT  
HAVE PROPPED UP INEFFICIENT INDUSTRIES WILL GRADUALLY  
COME DOWN. FOREIGN BANKS WILL PROBABLY BE ALLOWED IN  
BEFORE THE END OF THE YEAR. THIS IS EXPECTED TO INCREASE  
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COMPETITION FOR DOMESTIC BUSINESS AND RESULT IN MORE LOAN  
AVAILABILITY FOR NEW INDUSTRY, AS THE FOREIGN BANKS  
SHOULD BE WILLING TO DO BUSINESS FOR SOMEWHAT LESS THAN  
THE ENORMOUS (BY US STANDARDS) SPREADS TRADITIONALLY  
DEMANDED BY CONSERVATIVE SPANISH BANKERS.

5. SHORT TO MEDIUM TERM PROSPECTS. THE UNEMPLOYMENT AND PRODUCTION COSTS OF THE AUSTERITY PROGRAM HAVE BEEN HIGH AND SPAIN IS STILL IN FOR A VIRTUAL ECONOMIC STANDSTILL FOR THE NEXT ONE TO TWO YEARS. UNEMPLOYMENT IS BETWEEN 850,000 AND 1,000,000 AND STILL GROWING (6.3 TO 7 PERCENT WITH SOME ESTIMATES AS HIGH AS 8 PERCENT). DOMESTIC DEMAND IS FLAT. BUSINESS CONFIDENCE IS LOW. ZERO TO ONE PERCENT IS THE LIKELY GROWTH FIGURE FOR 1978 AND PRIVATE INVESTMENT CONTINUES TO FALL AS IT HAS FOR THE LAST THREE YEARS. CAPACITY UTILIZATION WAS DOWN TO 81 PERCENT AT THE END OF 1977. THE STRUGGLE NOW GOING ON IN THE CORTES TO PRODUCE A NEW SYSTEM OF LABOR LEGISLATION HAS MADE MANY BUSINESSMEN ANXIOUS OVER THE DEGREE OF UNION POWER AND INFLUENCE THEY WILL HAVE TO CONTEND WITH IN THE FUTURE. PROSPECTIVE INVESTORS ALSO ARE CONCERNED ABOUT THE POLITICAL STRENGTH OF THE SOCIALISTS, WHO TRY TO BE REASSURING ABOUT THEIR SHORT-TERM ECONOMIC PROGRAM, BUT HAVE NOT BEEN ABLE TO CONVINCE THE BUSINESS COMMUNITY.

- ON THE POSITIVE SIDE, THE CURRENT ACCOUNT DEFICIT APPEARS TO BE UNDER CONTROL FOR THE PRESENT. IN FACT, PRELIMINARY FIGURES SHOW A \$92 MILLION SURPLUS FOR JANUARY 1978, AND A CURRENT ACCOUNT DEFICIT OF ONLY \$1.5 BILLION FOR THE YEAR, DOWN FROM \$2.5 BILLION FOR 1976. TOURISM IS UP 30 PERCENT IN THE FIRST QUARTER AND FOREIGN EXCHANGE RESERVES ARE APPROACHING AN ALL TIME HIGH. THE PESETA HAS GAINED SOME AGAINST THE DOLLAR. INFLATION HAS BEEN REDUCED AND THE 17 PERCENT TARGET

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FOR 1978 IS WITHIN REACH, ALTHOUGH FAR FROM CERTAIN.

IT IS TOO EARLY TO SAY WHETHER THE ECONOMY HAS BOTTOMED OUT YET OR NOT. SPAIN'S MAJOR TRADING PARTNERS IN EUROPE ARE STILL IN LOW GROWTH PERIODS AND ARE RELUCTANT TO TAKE LARGER QUANTITIES OF SPANISH EXPORTS; EITHER AS MERCHANDISE OR SURPLUS LABOR.

- THE POLITICAL TRANSITION IS GOING WELL, BUT SPAIN DOES NOT YET HAVE A CONSTITUTION (ALTHOUGH THE SIGNS ON THAT SCORE ARE GOOD). BASIC LABOR LEGISLATION IS STILL LACKING, AND MANY OF THE MORE CONSERVATIVE GROUPS, POLITICAL AS WELL AS BUSINESS, FEAR A GROWING SOCIALIST PRESENCE.

- PARLIAMENTARY AGREEMENT UPON AND NATIONAL RATIFICATION OF A CONSTITUTION, TO BE FOLLOWED BY MUNICIPAL AND NATIONAL ELECTIONS (THE ORDER AS YET UNDECIDED) IS STILL AHEAD AND MAY NOT BE COMPLETED UNTIL SOMETIME IN 1979, IF THEN. IF THE POLITICAL PROCESS CAN PRODUCE A WORKABLE CONSTITUTION THAT YIELDS A REASONABLY STABLE PARLIAMENTARY

SYSTEM, LED BY PARTIES OF DEMONSTRABLE MODERATION, THEN  
IMPORTANT PREREQUISITES FOR A RESTORATION OF CONFIDENCE  
IN THE FUTURE WILL HAVE BEEN ACHIEVED. THIS WOULD DO MUCH  
TO ENCOURAGE PRIVATE INVESTMENT TO RETURN TO THE MARKET.  
THIS IS CLEARLY A KEY FACTOR, BECAUSE, TO A MUCH GREATER  
EXTENT THAN IN THE OTHER OECD COUNTRIES, WHERE THE PUBLIC  
SECTOR HAS MORE WEIGHT, THE ULTIMATE HEALTH AND GROWTH OF  
THE SPANISH ECONOMY IS DEPENDENT ON PRIVATE INVESTMENT,  
BOTH DOMESTIC AND FOREIGN. TO ENCOURAGE THIS INVESTMENT,  
GOVERNMENT MUST PROVE IT CAN RESTORE ECONOMIC STABILITY  
BY HOLDING FIRM ON ITS AUSTERITY PROGRAM, WHILE ALSO  
MAINTAINING POLITICAL MODERATION. EATON

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## Message Attributes

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